

**DEPARTMENT OF STATE REVENUE**

**FIRST SUPPLEMENTAL LETTER OF FINDINGS 94-0098**

**Sales and Use Tax**

**For the Period Ending: 12/31/90 Through 12/31/92**

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**ISSUES**

**I. Use Tax - Exempt Purchases**

**Authority:** IC 6-2.5-5-1; IC 6-2.5-5-2; IC 6-2.5-5-3; 45 IAC 2.2-5-8; Indianapolis Fruit v. Dept. of State Rev., 691 N.E.2d 1379 (Ind. Tax 1998); Indiana Department of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 525 (Ind. 1983)..

Taxpayer protests the Department's determination to impose use tax.

**II. Tax Administration - Liability for 10% Negligence Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-1 & 2

Taxpayer protests the Department's determination to impose the 10% negligence penalty.

**STATEMENT OF FACTS**

The Taxpayer is an Indiana corporation, headquartered and domiciled in this State. It is engaged in the business of providing food services to customers throughout Indiana. The Taxpayer leases a large food service fleet capable of delivering, preparing or both, the raw food at the customer's site. In this audit, the Department determined that the Taxpayer failed to self-assess use tax on a wide-variety of nonexempt purchases. The Taxpayer protests this determination.

**I. Use Tax - Exempt Purchases**

**DISCUSSION**

In the rehearing, the Taxpayer continued to protest the Department's decision to uphold the

imposition of use tax on rental payments made to “J”, Inc. for the mobile kitchens, citing IC 6-2.5.-5-3, and Indianapolis Fruit v. Dept. of State Rev., 691 N.E.2d 1379 (Ind. Tax 1998). The Department’s finding in the original Letter of Finding partially sustained and partially denied the taxpayer’s protest. The taxpayer was required to submit a schedule of rental income as well as an apportionment schedule dividing the rental income payments between the transportation and food production or processing functions. However, the taxpayer requested a rehearing stating that the Tax Court’s decision in Indianapolis Fruit would exempt the mobile kitchen from tax.

At issue in Indianapolis Fruit was whether the equipment used in ripening bananas and tomatoes was exempt pursuant to IC 6-2.5-5-1 through 3 (sections 1&2 exempt tangible personal property used in agricultural production, section 3 is the equipment exemption that exempts manufacturing machinery, tools, and equipment used to produce other tangible personal property). The exemptions the taxpayer claimed all required the taxpayer to be engaged in the production process before qualifying. The central questions were whether the ripening process constituted production. The Tax Court ruled that the banana ripening process was production because the bananas underwent substantial changes as they ripened, and the taxpayer’s process actively induced those changes by exposing the bananas to ethylene gas. That transformation made the bananas marketable. In its opinion the Court stated:

Indianapolis Fruit is entitled to a sales and use tax exemption for all items integral and essential to the production of the ripened bananas. The evidence in this case shows that the production process begins with the placement of the bananas in the ripening booths for exposure to the ethylene gas. The production process ends when the bananas are at their optimal ripeness and have been packaged for shipment...(Production “begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.”). Accordingly, Indianapolis Fruit is entitled to a sales and use tax exemption for all items used from the beginning to the end of this integrated production process....

The taxpayer argues that the food preparation undertaken by the taxpayer constitutes production. According to the taxpayer, the production of food begins in their own kitchens and continues while in transit in the mobile kitchens and is completed at the customer’s location so the food is fresh and/or hot. Therefore, the taxpayer contends that the mobile kitchens and all the equipment used to prepare the food is an integral and essential part of the production process.

The Department in the first Letter of Findings, recognized that the mobile kitchen serves at least three legitimate transportation purposes important to the Taxpayer’s catering operation: (1) performing a transportation function by hauling the raw food products and cooking equipment from warehouse to the customer’s location; (2) transporting equipment used for production or processing of raw food products into hot food fit for human consumption to the customers

location; and (3) transporting the equipment back to the warehouse after the event is completed.

Indiana Code section 6-2.5-5-3 (b) provides:

(b) Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

The Indiana Supreme Court has stated that this “statute provides that the manufacturing machinery, tools and equipment, in order to be exempt, must (1) be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.” Indiana Department of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 525 (Ind. 1983). Accordingly, the Taxpayer must present evidence to establish that it is a manufacturer, and that its use of the mobile kitchen satisfies this test.

The Department must determine whether the Taxpayer is involved in production or processing of food, and if so, determine when the production or processing begins and ends. The Department finds that the Taxpayer is engaged in the production or processing of food products, as its business is transforming raw food into hot food fit for human consumption. The production or processing activities create a marketable product and thereby increases the number of scarce economic goods. In order for the mobile kitchen to qualify for the exemption, it must be an integral part of the production or processing of raw food into hot food fit for human consumption.

Critical to this determination is defining the beginning and ending of the cooking production or processes. Other than its general statement that “[t]he cooking process can be started enroute (sic) to the customer’s location and finished on site in order to deliver freshly cooked, hot food,” the Taxpayer has not presented any specific evidence of when the cooking process begins for its menu items. (See, Letter of Protest, para. 1 (January 14, 1994)) (emphasis added). The Department finds this statement, standing alone, insufficient to prove that food production or processing begins en route to the customer’s site.

Relying upon the information in the audit file, the Department determines that the cooking process most likely begins only after the mobile kitchen arrives at the customer’s site. Unlike the vehicles used in Cave Stone which were not licensed for public highway use (they were used almost exclusively for hauling crude stone between production processes at Cave Stone’s plant), is licensed for public highway use. Accordingly, this equipment can be used for transportation functions which occur outside the food production or processing phase.

The Indiana Tax Court in Indianapolis Fruit exempted the booths and all items used from the beginning to the end of the production process. However, the taxpayer's building that housed the production process was not exempt. Similarly, the equipment used to cook the food in this

instance is exempt as integral and essential to the production process, but the mobile kitchen does not act upon the food or have any function other transportation. A vehicle used to move food from one location to another is not integral or essential to manufacturing of the food.

### **FINDING**

The Department finds that to the extent the equipment is used to transport raw materials to the customer's site, the transportation occurs prior to the production process which causes the rental payments for such use to be subject to the use tax. 45 IAC 2.2-5-8(1). After the mobile kitchen arrives at the customer's site, the food production or processing begins. Rental payments for food production or processing equipment are exempt from the use tax, as these items are directly used in the direct production of raw food into hot food fit for human consumption. IC 6-2.5-5-3. Return transportation of the unit to the warehouse occurs after the production or processing phase. To the extent the rental income is apportioned to transportation before and after production or processing it is subject to use tax, and to the extent the rental income is for equipment used in the direct production of hot food, it is exempt from the use tax.

## **II. Tax Administration - Liability for 10% Negligence Penalty**

### **DISCUSSION**

The taxpayer protests the Department's imposition of the ten percent (10%) penalty assessment. Indiana Code section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent in nature.

Departmental regulation 45 IAC 15-11-1(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also to be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayer must show that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. ..."

In this instance, the taxpayer has shown reasonable cause. The taxpayer has provided to the Department's satisfaction, sufficient justification for interpreting the code as it did.

**FINDING**

The taxpayer's protest is sustained. The taxpayer has provided to the Department's satisfaction, sufficient justification for interpreting the code as it did.